Cash Balance Plans

A cash balance plan is a defined benefit or pension plan where an employer credits a participant's account with a percentage of their annual compensation plus interest accruals. As with all defined benefit plans, the investment risk and plan's funding requirements are borne by the employer. Investments are professionally managed and participants are promised a guaranteed benefit at retirement. Unlike a traditional defined benefit or pension plan, a cash balance plan has individual account balances similar to a 401(k) plan and the promised benefit is a 401(k) type account balance rather than monthly income. Gains or losses to plan investments do not affect the final benefits the participant will receive at retirement so the company bears all of the risk to properly fund the plan even if the plan earnings are not adequate to provide the promised benefits. Older business owners find cash balance plan attractive because the contribution limits increase with age, unlike the static limits in 401(k) plans. Cash balance plans can help an owner save a large amount for retirement while producing significant tax savings.

Cash balance plans are defined benefit plans with a 401(k) twist

NOBLE-DAVIS CONSULTING, INC.

30275 Bainbridge Road
Building B
Solon, OH 44139

Phone: 440-498-8408
Fax: 440-498-9566
E-mail:
contactus@noblepension.com

PLAN SPONSOR SERIES
AUGUST 2017

Pros and Cons of a Cash Balance Plan

Pros	Cons
Much larger annual contributions available— over $200,000 in a cash balance plan vs. $60,000 for a 401(k) plan	Has an annual required contribution of roughly 5-8% of compensation for all eligible employees
Contributions limits increase as business owners are closer to retirement allowing them to turbo-charge their retirement savings	Participants also receive an interest credit that could be a fixed or variable percentage. If the investments do not earn this target amount then the employer must fund the difference
Plan contributions reduce the employer's net taxable business income resulting in significant tax savings	Cash balance plans require the services of an actuary and are much more costly than a 401(k) plan. Setup fees can be $2,000-$5,000 and administration costs can be $2,000-$10,000 annually
Because cash balance plans mimic the individual account of a 401(k) plan, they are easier for participants to understand than the traditional defined benefit or pension plan	Termination of a cash balance plan is even more costly. A cash balance plan should be in existence for at least 3 years in order to recoup the money spent on installation and termination fees
The funding for cash balance plans is generally more flexible than for 401(k) plans	Participants are promised a certain interest rate for earnings. If the investments don't actually earn that amount, the company will be liable for the difference
Cash balance plans are ideal for companies where owners, partners or key employees want to contribute more	Many cash balance plans are covered by the PBGC (Pension Benefit Guaranty Corporation) which requires an annual premium of $69 per participant plus a variable rate based on the plan's funding status
Cash balance plans are ideal for stable businesses not affected by large economic swings	Cash balance plans are under greater scrutiny from the Internal Revenue Service, the Department of Labor and the Pension Benefit Guaranty Corporation
Cash balance plans are ideal for plans with older key employees and younger staff	Cash balance plans are not recommended for businesses with good years and bad years since there could be a sizable required contribution each year

401(k) Benefit Examples

- Match of 50% on the first 6% of deferrals
- Profit Sharing contribution of 3% of compensation
- A $20,000 contribution prorated based on compensation

Cash Balance Plan Examples

- Contribution of 5% of compensation with a 5% interest credit
- Contribution of 8% of pay with an interest credit equal to the 30-Year Treasury rate

Defined Benefit Plan Examples

- $500 per month
- $50 per month times years of service
- 2% of career earnings
- 2% average salary times years of service